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Summary

¶1. (SBU) Russian oil and gas companies are cutting back on capital expenditures and trimming costs where possible as they try to ride out the financial crisis and adjust to lower oil prices. Even state-owned Gazprom and Rosneft, despite having held to earlier investment plans through the end of 2008, have now announced 2009 expenditure cuts. Under pressure from the GOR to maintain employment, no company has announced major layoffs as a cost-cutting measure. Despite support from a weak ruble and dropping prices for inputs, we will likely continue to see the sector retrench absent a major uptick in oil prices or a credit thaw. End summary.

FACING REALITY

¶2. (SBU) Until late October 2008, despite widespread expectations that the Russian oil and gas sector would have to make painful adjustments to new financial and economic realities, no company had officially announced major cutbacks in expenditures or investments (ref C). As the crisis wore on, however, and GOR officials themselves began to publicly accept its impact, the major oil and gas companies (Rosneft, Lukoil, TNK-BP, and Gazprom/Gazpromneft) slowly changed their tune. The private major companies, Lukoil and TNK-BP, were the first to announce revisions to their original 2009 investment and spending plans.

¶3. (SBU) In 2008, Lukoil had $12 billion of capex expenditures (capex) and expected to spend another $11 billion in 2009. In late October 2008, however, Lukoil suggested 2009 capex would be cut to $7.5 - $9 billion. In February, the company again cut its capex forecast for 2009 to just $6.5 billion. In March 2008, TNK-BP expected 2009 capex of $4.5 billion. By December 2008 the figure was cut by 30% to just $3.3 billion and in January 2009 it was cut again to $3 billion.

¶4. (SBU) In contrast, state-owned Rosneft and Gazprom were steadfastly sticking to ambitious capex plans until early
¶2009. Vlad Konovalov, head of the Petroleum Advisory Forum,

an association of international oil companies in Russia, told us recently that the divergent stances of the private and state-owned companies indicated to him that the state companies are being directed by the GOR and not by economic considerations.

¶5. (SBU) By February and March 2009, however, even the state giants had to acknowledge that their plans would have to be scaled back. As of February 2009, Rosneft was still suggesting 2009 capex would increase by 11% in ruble terms (implying a 15 - 20% cut in dollar terms). By March, Rosneft had shifted its guidance, saying 2009 capex would equal 2008 capex in ruble terms (a 25 - 30% cut in dollar terms). Gazprom has been the most reluctant to revise its spending plans downward. In March 2008, Gazprom planned to increase its capex in 2009 by 40% to 700 billion rubles and again by another 20% in 2010 to 850 billion rubles. Through January 2009, Gazprom was publicly and privately (refs A and B) claiming it was moving ahead with all investment plans and did not expect to change them in light of the financial and economic crisis. By February 2009, however, Gazprom admitted it would have to prioritize spending, and proposed 2009 capex of under 500 billion rubles. Gazpromneft, Gazprom's oil subsidiary, provided reduced capex guidance ahead of its parent, in December 2008. At that time, Gazpromneft announced various capex reduction scenarios depending on the oil price. At $70 per barrel, 2009 capex would drop 25%; at $50 per barrel, capex would be cut 35%; and at $32 per barrel, Gazpromneft expected to cut 2009 capex by 45%.

GOR PRESSURE TO AVOID STAFF CUTS

¶6. (SBU) Even as the GOR has apparently allowed the state giants to reduce capex plans it has kept the pressure on all companies in the sector to maintain employment and avoid staff cuts wherever possible. While several oil and gas companies have reported minimal reductions in staff, none has announced major layoffs. According to analysts who sat in on a conference call in March, Rosneft has suggested it "may cut several thousand" of its approximately 106,000 employees, but it has not yet taken any official action. Both Gazprom and Gazpromneft recently announced headquarters staff reductions, but those cuts amount to only a few hundred of Gazprom's several hundred thousand employees.

¶7. (C) TNK-BP COO Tim Summers (protect) told us recently that the GOR is applying "tremendous pressure" on his and other companies to avoid layoffs. He said TNK-BP would "try to comply" but that his company has already cut 450 staff in Moscow and will leave another 150 vacancies unfilled. Summers said he had heard that Gazpromneft, in response to government pressure, had canceled a major order for American drilling equipment in order to avoid laying off the additional staff needed to operate the less efficient current equipment.

BUT COST-CUTTING THE PLAY OF THE DAY

¶8. (SBU) While avoiding layoffs for now, the companies are taking other measures to save money. Summers told us TNK-BP has switched how it pays its vendors, changing its policy from payment within 30 days to payment within 60 days, a move he explained would save his company millions of dollars. He added that TNK-BP will be "extremely prudent" in managing cash this year. According to Summers, 2009 and 2010 will "weed out the inefficient."

¶9. (SBU) Rosneft has publicly announced a major cost-cutting initiative, including reducing bonuses, but has revealed no further details. According to press reports, the major oil

and gas companies are also considering cuts in charitable contributions. The major companies reportedly spent a combined $1.5 billion per year over the past two years in charitable giving, but that figure is expected to drop in ¶2009. Dividend payments are also reportedly under review at all the major companies as they balance the need to maintain investor interest and the need to conserve cash for operations and investments.

WEAK RUBLE AND LOWER INPUT COSTS WILL HELP

¶10. (C) Despite the gloomy outlook for the oil and gas sector in general, two factors will help the companies' bottom lines -- rapid deflation in the price of oil and gas sector inputs and ruble depreciation. Summers told us that the prices of many inputs used by the oil and gas sector have dropped by 30% recently, and are likely to continue to drop in the near-term.

¶11. (C) Summers also told us that the sector has recently benefited from changes in the exchange rate, which are tied directly to the oil price. He explained that when the oil price goes down, the ruble weakens, and expenses in dollar terms drop, partly off-setting the fall in prices. Rosneft CFO Peter O'Brien told us recently that the weak ruble is a major contributor to Rosneft's bottom line as its expenses are largely in rubles and its earnings in dollars.

COMMENT

¶12. (SBU) The size and geographic dispersion of the oil and gas sector means cutbacks in expenditures will have major impacts across Russia. In addition to billions of dollars in purchases from vendors and in salaries to staff, in many small towns they provide needed funds for schools, roads, and

hospitals both directly as part of their "social obligations" and indirectly through tax payments. Given the sector's massive debts and given continued global economic uncertainty, the situation will likely get worse before it improves. Absent a major change in the credit environment or a sharp increase in oil prices, we would expect to see further cuts in capital and operational expenditures announced later in 2009.
BEYRLE